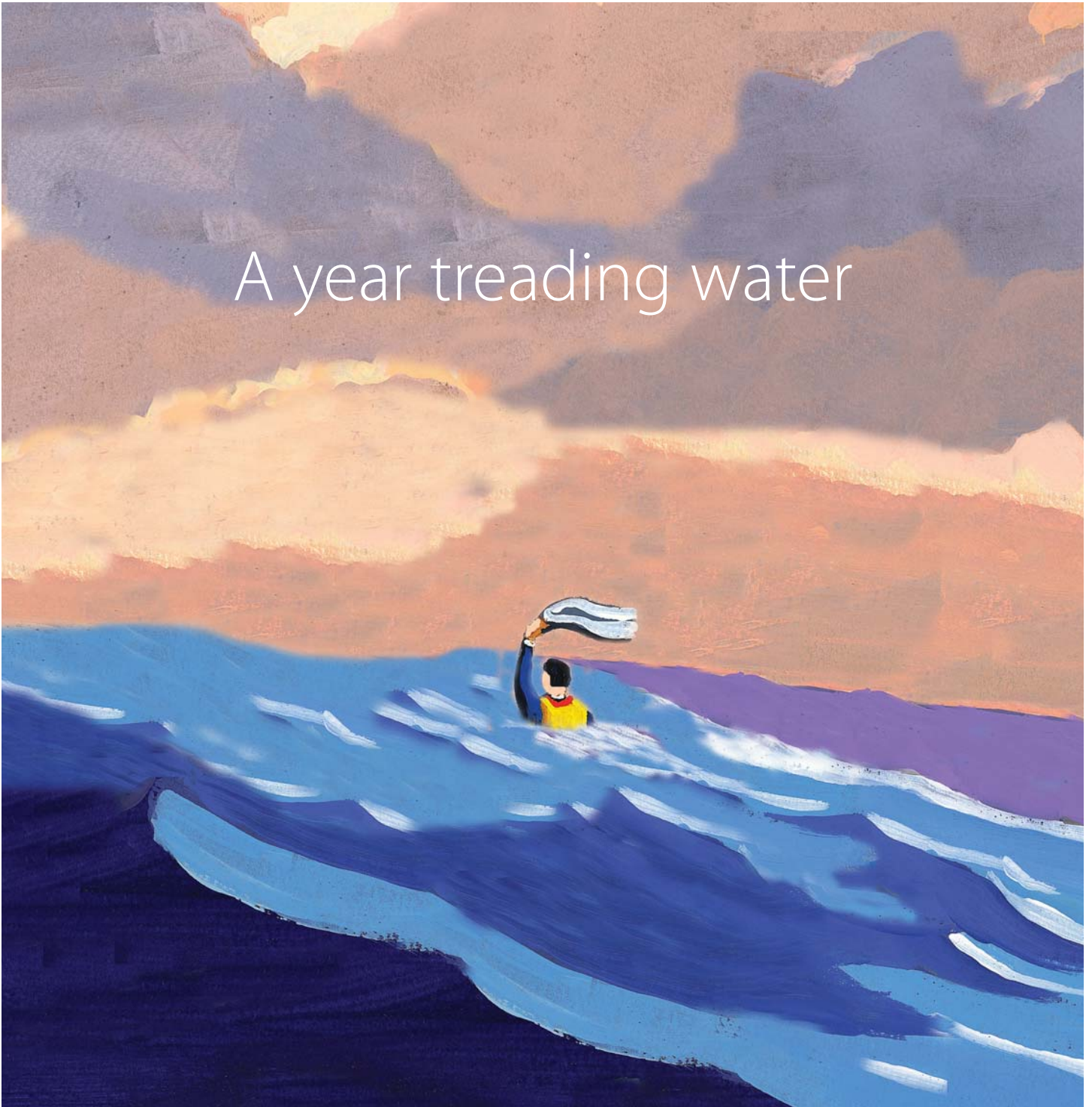


The PERAC Financial Bulletin

Financial Market Review, Fourth Quarter 2005

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A year treading water



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Q4

For the US, 2005 was an unusual year that saw both the stock and bond markets basically tread water. The economy grew at a healthy clip and profit growth was impressive, yet, contrary to what would be expected under these conditions, stock prices failed to rise appreciably and bond prices stubbornly refused to fall. As a result, both the stock market and the bond market closed out the year very close to where they started, making it very difficult for pension plans who invest solely in these markets to meet their targeted rates of return.

EQUITY MARKETS

For stocks, which typically register either decisively positive or negative performance, a year of flat performance is highly unusual. Considering the Dow Jones Industrial Average, its return of -0.61% was its smallest percentage change since 1926 and its low-to-high range of about 10% was far below average.

Despite record high oil prices, devastating hurricanes, and rising short-term rates, the economy was projected

to have grown at a 4.1% rate and earnings growth for the S&P 500 companies was estimated at almost 14%. Nevertheless, even after modestly positive returns for the fourth quarter, the S&P 500 was up only 3.00% (excluding dividends) for the year and the NASDAQ composite was up only 1.37%. One plausible explanation for the market's weak performance is that it is still working off the excesses of the late 1990s. Indeed, at year-end, the S&P 500 was still 18% below its record high reached in March 2000 and the NASDAQ

Chart 1

S&P 500 in 2005: Up Slightly

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Chart 2

S&P 500: Five-Year Perspective

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Composite was still 56% off its record. One index that has achieved a new peak is the Russell 2000, reflecting the fact that small caps confounded many experts by outperforming large caps (S&P 500) for the sixth consecutive year, although the 2005 margin was very small. By a decisive margin, mid-caps outperformed both small caps and large caps last year. Over the past five years, the annualized total return for the Russell 2000 (+8.22%) and the S&P MidCap 400 (+8.60%)

far exceeded that of the S&P 500 (+0.54%). In style comparisons, there was no significant advantage between growth and value in 2005, although—after five years of dominance by value—growth appeared to be gaining the upper hand during the latter part of the year.

As always, even with muted returns overall, it was a stock-pickers market. Among the sectors of the S&P 500, energy was up 29% and utilities rose

13%, while telecom services declined 9% and consumer discretionary fell 7%. Among individual stocks, Apple was up 123% while Google spurred 115%. Reflecting the erosion of America's manufacturing prowess, General Motors and Ford were down 52% and 48%, respectively.

An important corollary of the market's lackluster advance despite strong growth in corporate profits is that price/earnings ratios have declined

Chart 3

S&P 500: 10-Year History

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Chart 4

S&P 500 vs NASDAQ: Ten Years Despite the Bubble, About Even

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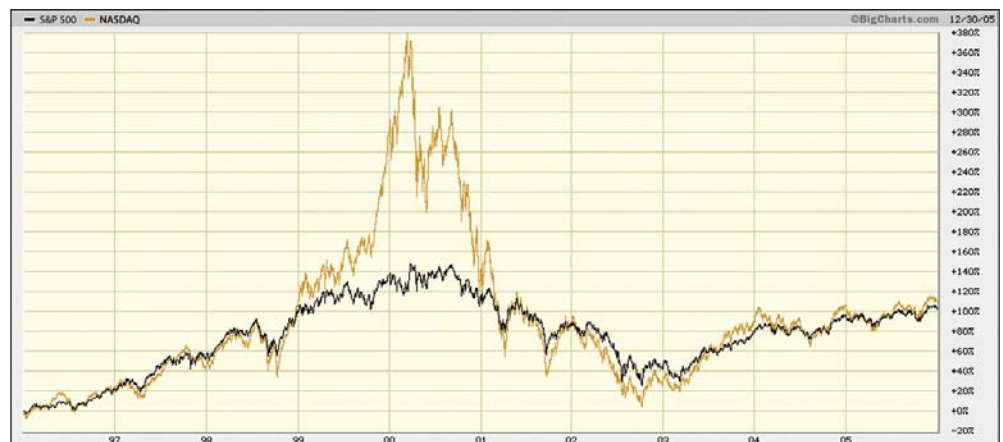
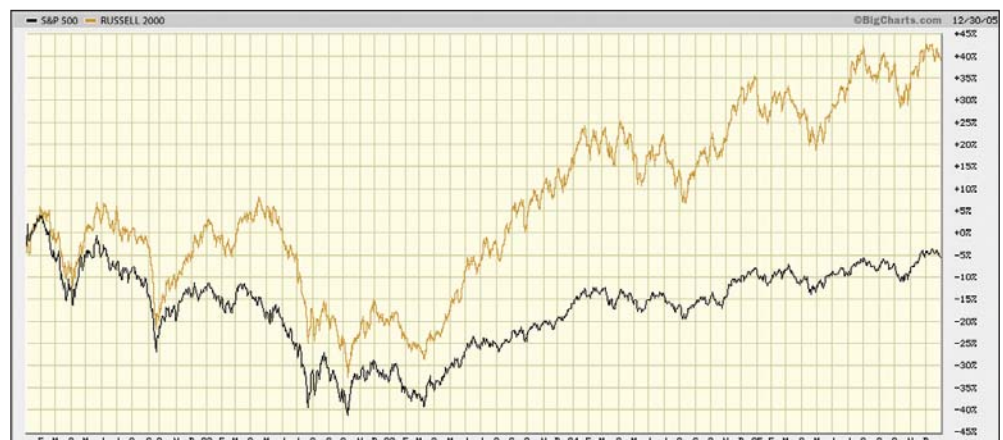


Chart 5

Russell 2000 vs S&P 500: 2001-05 Small Caps Rule

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considerably. At about 18 at year-end, the P/E on the S&P 500 was close to its long-term average range of 15 to 16 and down considerably from the high of 40 reached during the bubble of the late 1990s.

For the third straight year, foreign stocks outperformed their US counterparts, as the MSCI-EAFE index rose 13.54% during 2005. Japan was at last enjoying a sustainable economic recovery, Latin America benefited from rising commodity prices and greater economic stability, Asia reaped the benefits of substantial inflows of foreign capital, and European markets surged as corpo-

rate restructuring led to greater than expected profit growth. For the past three years, the annualized return on MSCI-EAFE was 23.7%, compared to 14.4% for the S&P 500. Emerging markets registered another year of extraordinary gains as the MSCI-EM Index rose nearly 34%; this segment has had an annualized return of 37.9% over the past three years.

US investors would have profited even more from their investments in foreign stocks were it not for the surprising strength of the US dollar. Our currency was up about 15% versus both the Euro and the yen as the attractiveness of high interest rates in

the US outweighed concerns over our large trade deficit. In local currency terms, the return on the MSCI-EAFE was 29% last year (in comparison to the dollar-adjusted return of 13.54%).

THE BOND MARKET

For the second straight year, predictions of higher long-term interest rates in the face of stronger economic growth have proven wrong. The Federal Reserve continued its tightening as the Federal Funds rate was lifted from 2.25% to 4.25%. Nevertheless, in a development that even Chairman Greenspan referred to as a “conundrum” earlier in the

Chart 6

After Continued Fed Tightening,
Rates Still Historically Low

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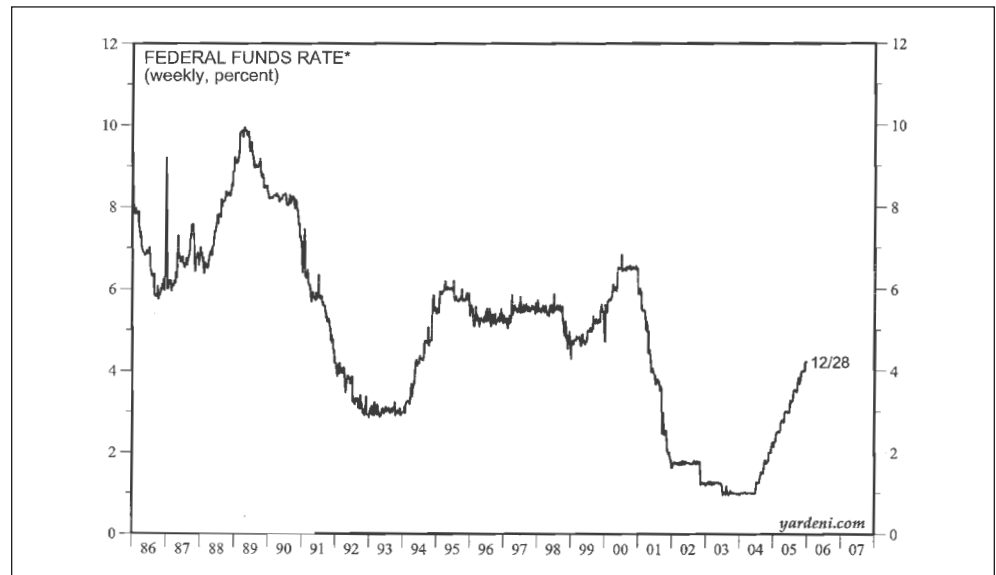
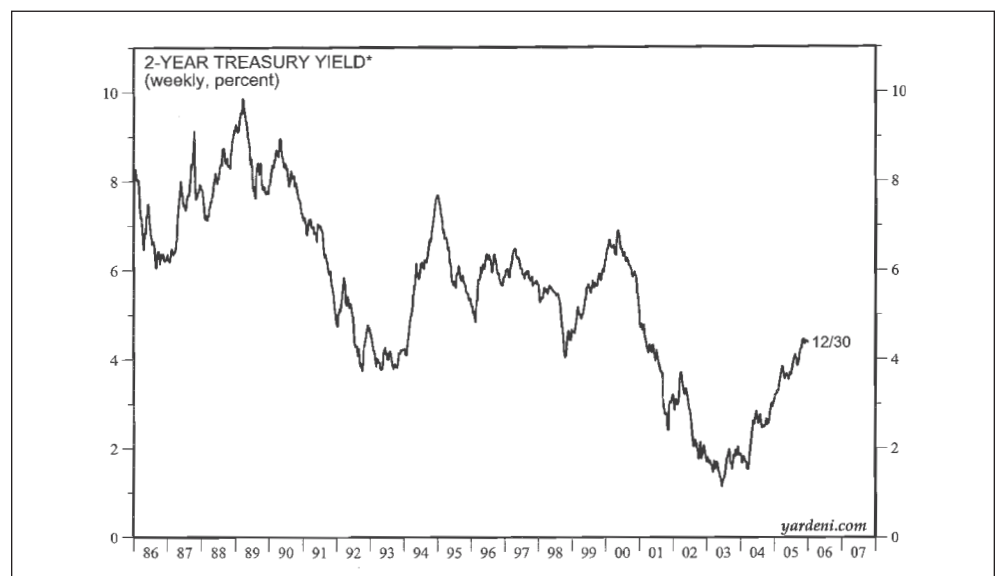


Chart 7

Two-Year Interest Rates Are Rising,
But Still Low

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year, rates on the benchmark 10-year Treasury note increased only modestly from 4.22% to 4.39%. Despite the fact the bonds of both General Motors and Ford were downgraded to below investment grade, the yield differential between high yield bonds and Treasuries widened only slightly, remaining well below the historical average. The Lehman Brothers Aggregate Index registered a return of 2.43% for the year while, within the index, performance for corporate and mortgage-backed bonds were generally in line with those of Treasuries. High yield bonds performed slightly better than the investment grade universe last year,

but they have provided superior performance over the past three years; as measured by the Merrill Lynch US High Yield Index, their annualized return was 13.44% versus 3.62% for the Lehman Aggregate.

At year-end, the bond market faced the unusual situation of an “inverted” yield curve for US Treasuries, where the 2-year interest rate slightly exceeded that of the 10-year. (Usually, long maturities carry higher yields than short maturities.) This phenomenon has clear negative implications for institutions, notably banks, which profit by borrowing short and lending long, but there was debate

over the most frightening possible implication of the inverted curve: that it has historically been the harbinger of a recession. Skeptics minimized the curve’s significance at this time by asserting that long rates were being kept artificially low as a result of continued heavy purchases by foreign central banks.

OTHER ASSET CLASSES

Real estate continued to offer impressive diversification benefits versus US stocks and bonds. While the residential housing market was under selling pressure in most regions, commercial real estate continued to be

Chart 8

10-Year Rates Have Remained Stable

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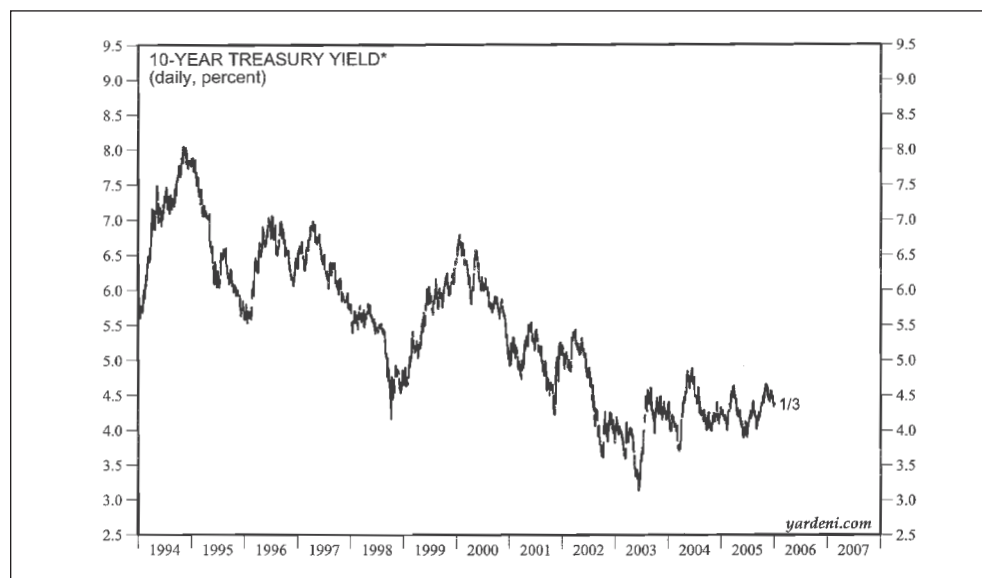
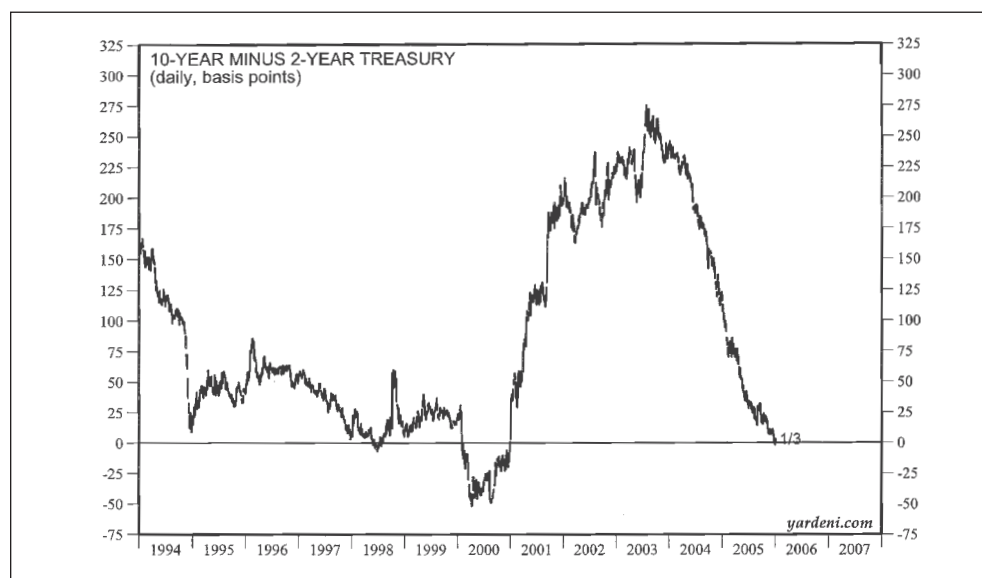


Chart 9

The Yield Curve Has Flattened

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strong. Although quarterly returns have been on a downward trend after extraordinary gains over the previous two years, publicly-traded Real Estate Investment Trusts still rose 12.16% for the year. Over the past five years, the annualized return from REITs was 19.08%, compared to 0.54% for the S&P 500. The NCREIF Index of private real estate investments (apartments, industrial, hotels, office, and retail) was indicating annualized returns of about 19% through the end of the third quarter.

Performance results for venture capital and private equity are not yet available, but conditions in these crucial sectors were generally healthy as fundraising was proceeding well and valuations of initial investments were higher. Nevertheless, returns will likely be constrained by the weakness in the market for Initial Public Offerings, where both the number and the size of offerings were down from 2004 in line with the flat results of the public equity markets.

The hedge fund industry saw assets under management exceed \$1 tril-

lion in 2005, up from \$400 million five years ago. Composite year-end performance indicated single-digit returns higher than those of either US stocks or bonds but, nevertheless, somewhat disappointing to investors paying high fees for these products. As a result, there were indications of slowing growth during the latter part of the year. Among the many distinct strategies that comprise hedge funds, short-selling, emerging markets, macro, and distressed debt posted positive returns while convertible arbitrage posted a loss. It is generally agreed that the lack of volatility in the markets has diminished the existence of market aberrations and inefficiencies that hedge fund managers seek to profit from and that the huge inflow of money into hedge funds has further reduced the opportunities for profitable trading. There were some high profile hedge fund frauds and failures during 2005—most notably Bayou Management—and the industry awaited with uncertainty the official beginning of SEC regulation on February 1, 2006.

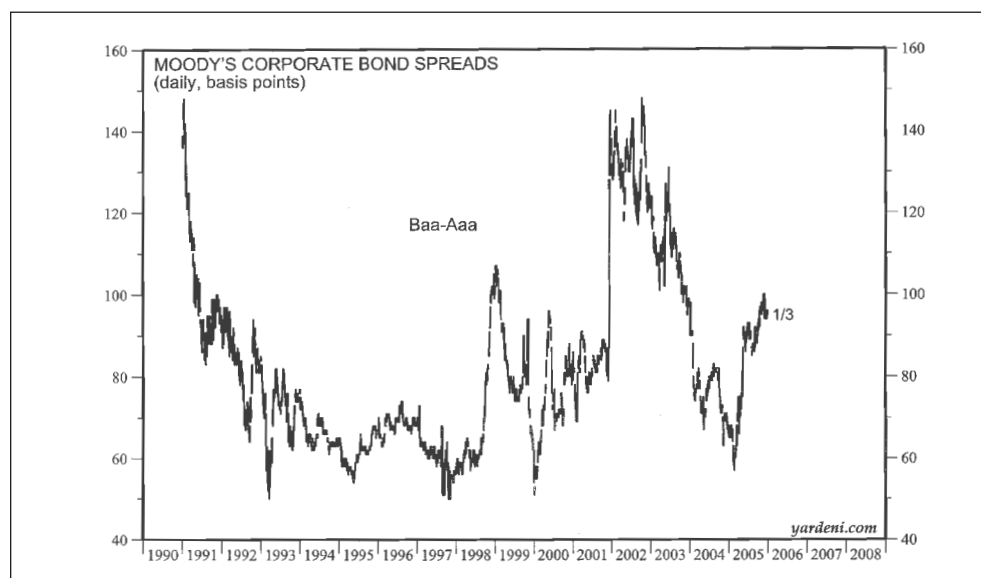
This year's markets have once again

vividly demonstrated the vital importance of diversified asset allocation. It is increasingly apparent that it is not sufficient to invest solely in large cap US equities and in high-grade US bonds. A well-balanced investment program should also have allocations to small and mid-cap stocks and to higher-yielding bond sectors and it should also invest internationally. Just as important, investors should consider the diversifying benefits of alternative asset classes such as real estate. Of course, it is equally vital to have consistently strong managers in all asset classes.

With a new Fed Chairman for the first time in almost 19 years and lingering uncertainties over energy prices, inflation, and economic growth, the investment outlook will continue to be challenging since no asset class appears particularly attractive or under-valued at this time. Trustees must continue to be very pro-active in positioning and monitoring their portfolios. At PERAC, we are committed to working closely with the Commonwealth's public retirement systems to help them meet their goals.

Chart 10
Quality Yield Spreads Have Widened
But Are Still About Average

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TOTAL RETURNS | FOURTH QUARTER, 2005

INDEX	FOURTH QUARTER 2005	TWELVE MONTHS 2005	FIVE YEARS 2001-05 (Annualized)
US EQUITY MARKET			
Dow Jones Industrial Avg.	+ 2.06%	+ 1.72%	+ 2.01%
Standard & Poor's 500 (Large Cap)	+ 2.09%	+ 4.91%	+ 0.54%
NASDAQ Composite	+ 2.50%	+ 1.37%	- 2.25%
Wilshire 5000 (Broad Market)	+ 2.32%	+ 6.32%	+ 2.12%
Standard & Poor's Mid-Cap 400	+ 3.34%	+ 12.56%	+ 8.60%
Russell 2000 (Small Cap.)	+ 1.13%	+ 4.55%	+ 8.22%
GROWTH VS. VALUE			
Russell 1000 (Large Cap) Growth	+ 2.98%	+ 5.26%	- 3.58%
Russell 1000 (Large Cap) Value	+ 1.27%	+ 7.05%	+ 5.28%
Russell Midcap Growth	+ 3.44%	+ 12.10%	+ 1.38%
Russell Midcap Value	+ 1.34%	+ 12.65%	+ 12.21%
Russell 2000 Growth	+ 1.61%	+ 4.15%	+ 2.28%
Russell 2000 Value	+ 0.66%	+ 4.71%	+ 13.55%
INTERNATIONAL EQUITY			
M.S.C.I. - E.A.F.E.	+ 4.08%	+ 13.54%	+ 4.55%
M.S.C.I. - Emerging Markets	+ 7.18%	+ 34.00%	+ 19.09%
FIXED INCOME			
Lehman Brothers Aggregate Index	+ 0.59%	+ 2.43%	+ 5.87%
Merrill Lynch High Yield Index	+ 0.66%	+ 2.74%	+ 8.39%
REAL ESTATE			
NAREIT - Equity Real Estate Investment Trusts	+ 1.54%	+ 12.16%	+ 19.08%
NCREIF Property Index	+ 4.44%	+ 19.19%	NA
	(Q3)	(Trailing 12 months)	